Association of Taxation Technicians

# Examination

November 2006

## PRINCIPLES OF ACCOUNTING

SOLUTIONS
(without marking guide)

Morris Limited - Answer 1

1. T accounts

Workings:

| | | | £ |
|---|---|---|---|
| W1 | No shares before bonus issue | Issued value | 125,000 |
| | | Nominal value | 0.25 |
| | | Number - 125,000/.25 | 500,000 |
| | No bonus shares - 500,000 x 7/2 | | 1,750,000 |
| | Nominal value of bonus shares - 1,750,000 x .25 | | 437,500 |
| W2 | No shares before rights issue - 500,000 + 1,750,000 | | 2,250,000 |
| | No of rights issue shares - 2,250,000 x 2/5 | | 900,000 |
| | Total proceeds from rights issue - 900,000 x 0.90 | | 810,000 |
| | Nominal value of rights issue shares - 900,000 x .25 | | 225,000 |
| | Share premium | | 585,000 |
| W3 | Nominal value of preference shares issued - 40,000 x £1 | | 40,000 |
| | Share premium - 40,000 x 0.20 | | 8,000 |
| | Total proceeds from issue | | 48,000 |

Ordinary share capital account

| | | | | | |
|---|---|---|---|---|---|
| | | | brought forward | | 125,000 |
| | | | bonus issue | W1 | 437,500 |
| carried forward | | 787,500 | rights issue | W2 | 225,000 |
| | | 787,500 | | | 787,500 |

Preference share capital account

| | | | | | |
|---|---|---|---|---|---|
| | | | brought forward | | 200,000 |
| carried forward | | 240,000 | share issue | W3 | 40,000 |
| | | 240,000 | | | 240,000 |

Share premium account

| | | | | | |
|---|---|---|---|---|---|
| | | | brought forward | | 175,000 |
| | | | rights issue | W2 | 585,000 |
| carried forward | | 768,000 | preference share issue | W3 | 8,000 |
| | | 768,000 | | | 768,000 |

P&L reserves

| | | | | | |
|---|---|---|---|---|---|
| bonus issue | W1 | 437,500 | | | |

Bank account

| | | | | | |
|---|---|---|---|---|---|
| rights issue | W2 | 810,000 | | | |
| preference share issue | W3 | 48,000 | | | |

Morris Limited - Answers

2. Ordinary and preference shares

Ordinary shareholders are the real risk takers and the effective owners of the company.

Preference shares usually pay a fixed rate of dividend which is paid in preference to ordinary shareholder dividends which are based upon how well the company performs

Preference shareholders are normally repaid their share capital before ordinary shareholders upon a winding up of the company.

3. Bonus issue

A bonus issue is when extra shares are issued to existing shareholders without any money having to be paid for them.

The extra shares are issued to existing shareholders in proportion to their present shareholdings

The nominal value of shares issued is credited to share capital and debited from reserves

The main reason for a bonus issue is in relation to quoted shares. The purposes is to reduce the market value of each share which hopefully increases its attractiveness to investors.

4. Rights issue

With a rights issue the company actually raises money through the issue of further shares

Often shares are issued at a favourable price to existing shareholders

Existing shareholders are given exclusive rights to take up the issue of new shares at a specific price

The number of shares a shareholder is entitled to acquire will be in proportion to existing shareholdings.

Usually a shareholder upon receipt of a right offer has three options:

1. Take up the rights
2. Sell the rights to someone else for them to take up
3. Do nothing and let the rights lapse

5. Cash flow

The bonus issue does not affect cash flow

The proceeds from the issue of the rights issue and preference share issue are shown as proceeds from the issue of shares in the cash flow statement

| | |
|---|---|
| Rights issue | 810,000 |
| Preference shares | 48,000 |
| Total proceeds in cash flow | 858,000 |

**Mr Ripley - Answer 2**

1. Profit and loss account

**Mr Ripley**

**Profit and Loss Account**

**Year Ended 31 May 2006**

| | | £ | £ |
|---|---|---|---|
| Sales | W4 | | 1,149,600 |
| Less cost of sales: | | | |
| Opening stock | W5 | 56,700 | |
| Purchases | W6 | 746,800 | |
| | | 803,500 | |
| Closing stock | W7 | (66,440) | |
| | | | (737,060) |
| Gross profit | | | 412,540 |
| Less expenses: | | | |
| Telephone | | 580 | |
| Electricity | | 980 | |
| Accountancy | | 1,400 | |
| Rent | W8 | 9,500 | |
| Wages | W9 | 1,750 | |
| Bad debts | W10 | 510 | |
| | | | (14,720) |
| Net profit | | | 397,820 |

2. Uses of the profit and loss account

The profit and loss account is a financial statements for a business and has the following uses:

It provides details of how the profit or loss has arisen during a particular period

It enables comparisons to previous periods in order to identify changes

It is the starting point for tax computations

Lenders find it useful

**Mr Ripley - Answers**

| Workings | | | | | £ |
|---|---|---|---|---|---|
| W1 | Purchases of product A - 820 x 140 | | | | 114,800 |
| | Cost of sales in year - 3/4 x 114,800 | | | | 86,100 |
| | Sales - 86,100 x 100/70 | | | | 123,000 |
| | Closing stock | | | | 28,700 |
| W2 | Sales of product B | | | | 725,000 |
| | Cost of sales - 725,000 x 100/145 | | | | 500,000 |
| W3 | Sales of product C - 520 x 580 | | | | 301,600 |
| | | | No | £ | |
| | opening stock - 210 x 270 | | 210 | 56,700 | |
| | purchases - 440 x 300 | | 440 | 132,000 | |
| | | | 650 | 188,700 | |
| | Cost of sales - average method | | (520) | (150,960) | |
| | closing stock | | 130 | 37,740 | |
| W4 | Sales: | Product A | | W1 | 123,000 |
| | | Product B | | W2 | 725,000 |
| | | Product C | | W3 | 301,600 |
| | | | | | 1,149,600 |
| W5 | Opening stock | | | | |
| | | Product C | | W3 | 56,700 |
| W6 | Purchases | Product A | | W1 | 114,800 |
| | | Product B | | W2 | 500,000 |
| | | Product C | | W3 | 132,000 |
| | | | | | 746,800 |
| W7 | Closing stock | | | | |
| | | Product A | | W1 | 28,700 |
| | | Product C | | W3 | 37,740 |
| | | | | | 66,440 |
| W8 | Prepaid rent at 31/05/2005 - 9,000 x 7/12 | | | | 5,250 |
| | Rent paid in year | | | | 10,200 |
| | | | | | 15,450 |
| | Prepaid rent at 31/05/2006 - 10,200 x 7/12 | | | | 5,950 |
| | | | | | 9,500 |

**Mr Ripley - Answers**

| Workings | | £ |
|---|---|---|
| W9 | Wages paid in year | 2,100 |
| | Less opening accrual | (350) |
| | | 1,750 |
| | | |
| W10 | Specific provision at 31/05/2006 | 3,000 |
| | General provision at 31/05/2006 - (58,000 - 3,000) x 2% | 1,100 |
| | Provisions at 31/05/2006 | 4,100 |
| | Provisions at 31/05/2005 - 6,500 + 1,190 | 7,690 |
| | | (3,590) |
| | Bad debt written off - 6,500 - 3,600 | 2,900 |
| | | (690) |
| | Bad debt written off | 1,200 |
| | | 510 |

Answer 3
Part 1

Interest paid account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 06.04.05 | Bank acc. | 8,000 | | | |
| 06.04.05 | Income tax acc. | 2,000 | | | |
| 28.06.05 | Bank acc. | 9,600 | | | |
| 28.06.05 | Income tax acc. | 2,400 | | | |
| 29.09.05 | Bank acc. | 8,800 | | | |
| 29.09.05 | Income tax acc. | 2,200 | | | |
| 24.12.05 | Bank acc. | 12,000 | | | |
| 24.12.05 | Income tax acc. | 3,000 | 31.12.05 | P & L acc. | 48,000 |
| | | 48,000 | | | 48,000 |

VAT Creditor account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 31.12.04 | VAT inputs | 90,000 | 31.12.04 | VAT outputs | 150,000 |
| 28.01.05 | Bank acc. | 60,000 | 31.03.05 | VAT outputs | 160,000 |
| 31.03.05 | VAT input | 110,000 | 30.06.05 | VAT outputs | 140,000 |
| 29.04.05 | Bank acc. | 50,000 | | | |
| 30.06.05 | VAT inputs | 150,000 | 15.08.05 | Bank acc. | 10,000 |
| 30.09.05 | VAT inputs | 120,000 | 30.09.05 | VAT outputs | 180,000 |
| 29.10.05 | Bank acc | 60,000 | | | |
| | | 640,000 | | | 640,000 |

Income tax account

| | | £ | | | £ |
|---|---|---|---|---|---|
| | | | 06.04.05 | Interest paid | 2,000 |
| 14.07.05 | Bank acc. | 4,400 | | | |
| | | | 28.06.05 | Interest paid | 2,400 |
| 14.10.05 | Bank acc. | 2,200 | | | |
| | | | 29.09.05 | Interest paid | 2,200 |
| 31.12.05 | Balance c/f | 3,000 | 24.12.05 | Interest paid | 3,000 |
| | | 9,600 | | | 9,600 |
| 14.01.06 | Bank acc. | 3,000 | 01.01.06 | Balance b/f | 3,000 |

Corporation tax account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 30.09.05 | Bank acc | 284,500 | | | |
| 17.11.05 | Bank acc. | 10,875 | 01.01.05 | Balance b/f | 284,500 |
| 17.11.05 | Bank acc. | 5,400 | | | |
| | | | 31.12.05 | P & L acc: Provision for the year to 31.12.05 | 300,000 |
| | | | | Underprovision for the year to 31.12.03 | 5,400 |
| 31.12.05 | Balance c/f | 300,000 | | 31.12.04 | 10,875 |
| | | 600,775 | | | 600,775 |
| | | | 01.01.06 | Balance c/f | 300,000 |

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Answer 3 (continued 1)

Deferred tax account

| | | £ | | | £ |
|---|---|---|---|---|---|
| 31.12.05 | P&L acc Reduction in Provision for Year to 31.12.05 | 11,000 | 01.01.05 | Balance b/f | 364,000 |
| 31.12.05 | Balance c/f | 353,000 | | | |
| | | 364,000 | | | 364,000 |
| | | | 01.01.06 | | 353,000 |

Bank account (extract)

| | | £ | | | £ |
|---|---|---|---|---|---|
| 15.08.05 | VAT refund | 10,000 | 28.01.05 | VAT | 60,000 |
| | | | 06.04.05 | Interest | 8,000 |
| | | | 29.04.05 | VAT | 50,000 |
| | | | 28.06.05 | Interest | 9,600 |
| | | | 14.07.05 | Income tax | 4,400 |
| | | | 29.09.05 | Interest | 8,800 |
| | | | 17.11.05 | Corporation tax | 10,875 |
| | | | 17.11.05 | Corporation tax | 5,400 |
| | | | 14.10.05 | Income tax | 2,200 |
| | | | 29.10.05 | VAT | 60,000 |
| | | | 30.09.05 | Corporation tax | 284,500 |
| | | | 24.12.05 | Interest | 12,000 |
| | | | 14.01.06 | Income tax | 3,000 |

Lever Limited
Profit and Loss account for the year ended 31 December 2005

| | £ |
|---|---|
| Corporation tax: | |
| Charge for the year at x% | 300,000 |
| Underprovision in respect of prior years | 16,275 |
| Deferred tax: | |
| Credit for the year | (11,000) |
| | 305,275 |

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Answer 3(continued 2)

Lever Limited

Balance Sheet as at 31 December 2005

| | |
|---|---|
| Creditors: amounts falling due within one year | |
| Taxation | 300,000 |
| Creditors: amounts falling due after more than one year | |
| Deferred taxation | 353,000 |

## Part 3

Deferred tax is the name given to an accounting adjustment which puts into practice the matching concept. Deferred tax recognises that if profits are shown in the profit and loss account the tax on these profits should be included as well. However, this is not always the case in practice due to the fact that accounting rules and tax rules differ. Deferred tax provisions are therefore set up to smooth out these differences. Examples of these differences are timing differences which arise with capital allowances and depreciation.

## Part 4

SSAP 5 offers guidance on how to account for VAT in company accounts. However, the principles apply equally to other business entities.

A person who is registered for VAT must charge VAT on supplies to customers. This is done by adding the rate of VAT applicable to the supply to the selling price. The VAT so charged is known as output VAT.

The output VAT must then be paid over to H M Revenue & Customs. The registered person is acting as a collector of VAT and because this VAT does not belong to the registered person it is excluded from the value of turnover in the accounts.

Businesses incur VAT on their purchases and expenses. This is known as input VAT and can be reclaimed from H M Revenue & Customs and consequently it is excluded from the value of purchases and expenses in the accounts.

Not all input VAT is recoverable, for example, VAT on customer entertaining is not recoverable.

Examples of journal entries are:

| | | |
|---|---|---|
| Dr Cash/debtor (VAT inclusive amount) | x | |
| Cr Sales (VAT exclusive amount) | | x |
| Cr VAT creditor (VAT amount) | | x |

Being journals to record a sale.



Answer 3 (continued 3)

Part 4 (continued)

| | | |
|---|---|---|
| Dr Expense (VAT exclusive amount) | x | |
| Dr VAT creditor (VAT amount) | x | |
| Cr Cash/creditor | | x |

Being journals to record a purchase.

Part 5

In company accounts tax appears in both the profit & loss account and the balance sheet as follows:

P & L account

| | | | |
|---|---|---|---|
| Profit before tax | | | x |
| | | | |
| Corporation tax charge/credit : | | | |
| Current year | | x | |
| Prior years | | x | |
| | | x | |
| Deferred tax charge/credit: | | | |
| Current year | x | | |
| Prior years | x | | |
| | | x | |
| | | | (x) |
| | | | |
| Profit after tax | | | x |

Balance sheet

| | |
|---|---|
| Creditors amount falling due within 1 year | |
| Corporation tax | x |

| | |
|---|---|
| Creditors: amount falling after more than 1 year | |
| Deferred tax | x |

In the accounts of a sole trader there is no requirement to show tax
because the tax liability is the personal obligation of the trader whereas a limited company is a separate legal entity and it is therefore the company not the company shareholders who are responsible for the tax.

**ANSWER 4:**

1. The basic purpose of accounting standards is to outline the accounting practice which the company is expected to follow on a particular topic or area.

   Financial statements which comply with accounting standards generate a common understanding between users and preparers of financial statements on how particular items have been treated.

2 The objectives against which an entity should judge the appropriateness of accounting
policies to its particular circumstances are:

- relevance
- reliability
- comparability; and
- understandability

3 A provision is a liability of uncertain timing or amount.

A provision should be recognised when an entity has a present obligation as a result of a past event and it is probable that a transfer of economic benefit will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

4. A contingent liability is a possible obligation that arises from a past event and whose existence will be confirmed only by the occurrence of one or more uncertain future events.

   In view of the uncertainty of a contingent liability they should not be provided for but may instead be referred to in the financial statements as they may have a material effect on the results of the business in the future. This reflects the requirement for the financial statements to give a true and fair view of the business' position.

5. A contingent asset is a possible asset that arises from a past event but whose existence will be confirmed only by the occurrence of one or more uncertain future events.

Prudence dictates that contingent assets are not included in the financial statements unless the outcome is virtually certain. However, mention of the possibility of the asset arising should be made so as to provide users of the financial statements with a true and fair view of the business' position.

6. The two concepts that play a persuasive role in financial statements and hence the selection of accounting policies are the going concern and accruals concepts.

   An entity should prepare its financial statements on a going concern basis unless the entity has been liquidated or has ceased trading or the directors have no realistic alternative but to liquidate the entity or to cease trading.

   The accruals basis of accounting requires the non-cash effects of transactions and other events to reflected as far as is possible in the financial statements for the accounting period in which they occur and not for example in the period in which any cash involved is received or paid.

7. The purpose of an accounting system is to be able to determine whether:

   a) the business is operating at a profit; and

   b) that the business can meet its liabilities as they fall due.

   An accounting system must enable a business to be able to answer the following questions:

   a) how well is the business doing?

   b) what does the business own?

   c) how much does the business owe?

8. The reserves of a company represent the cumulative total of the company's retained profits. These are the profits after taxation and after the distribution of any profits to the shareholders by way of dividends. The reserves form part of the shareholders' funds along with the share capital and the share premium account.

9. The 4 different ways in which a business can be carried on are:

   a) sole trader;

   b) partnership;

   c) limited liability partnership; and

   d) limited company.